Long-term capital gains in debt mutual funds set to go

In a move that could take away the long-term capital gains benefits for a majority of debt mutual fund schemes, one of the key amendments that the government is set to propose in the Finance Bill 2023, is that the taxation of capital gains of investors in debt funds which have 35% or less of their assets under management in domestic equities will be at the slab level, said sources close to the development.

Currently, investors in debt funds pay income tax on capital gains according to their income tax slab for a holding period of three years and after that, they are taxed at the rate of 20% with indexation benefits or 10% without indexation.

According to mutual fund heads, this proposal is likely to give a boost to bank fixed deposits and also pure equity funds and do away with the arbitrage between different debt instruments. Amit Maheshwari, tax partner, AKM Global said, "The proposal would take away the tax advantage for such funds and the investors may resort to alternate options such as fixed deposits." The objective is to plug a tax loophole used by high net worth individuals and family offices for investments.

In other key changes in the tax proposals in the Finance Bill 2023, before it is put to vote in Lok Sabha, sources said that the proposed income tax at slab rate on amortisation of debt in the hands of InvITs/REITs unitholders will be restricted to the excess sum received by them over the issue price, that is, the initial investment. Redemption of the units won't be a requirement for computing the gains, post the cost of acquisition.

This will lighten the burden of the new tax on infrastructure and real estate investment trusts and help address the concerns the new impost would dampen fresh investments in these instruments. Stakeholders have suggested that a capital gains tax would serve the purpose, given that it could reduce the rate (long-term rate is 10%, and short term gains are taxed at 15%) but the government is learnt to have not accepted this.

However, tax experts said, the base reduction to come from the proposed change, would provide a significant relief to the investors, though not as much as a shift to capital gains tax would have.

Further, investment vehicles helmed by the Abu Dhabi Investment Authority (ADIA) relocating to the GIFT IFSC may be made eligible for exemption from capital gains tax. The proposal is aimed to spur investments into India's International Financial Services Centres.

According to sources, the government is looking at a proposal under which an investment vehicle, in which ADIA is the direct or indirect sole shareholder or unitholder or beneficiary and the investment is wholly owned and controlled by the ADIA or the government of Abu Dhabi, will be able to get capital gains tax exemption on relocation to the IFSC.

The Financial Bill may be taken up for consideration and passage by the Lok Sabha on Friday.

As far as distribution of return on debt capital is concerned, the tax would continue to be at the slab rate of the investor as proposed in the Budget, with the receipts being treated as income from other sources. But, as per the changed proposal, the tax will apply on the sum distributed

by the trust minus the issue price. Also, in the coming years, the tax charged will be progressively deducted from the base.

Under the Sebi rules, listed infrastructure and real estate investment trusts (InvITs and REITs) are required to disburse at least 90% of the cash to unitholders.

The distribution is done as dividends, interest payment, rental income and loan repayment to the unitholders. The loan repayment component of income distributed by the trusts is particularly large in the case of InvITs.

While interest and dividend income is taxed at the hands of unit holders, the return of capital disbursed by InvITs is currently not taxed either in the hands of business trust or in the hands of unitholder.

Some business trusts might have used the loophole to return a very high amount of capital to the unit holders without a corresponding change in the acquisition cost of underlying units, in what would have led to undue benefit to them at the time of the subsequent sale of units. This may have been the reason for the government to bring in the new impost.

"The government has now taken a pragmatic approach. The sum received by unitholders will compulsorily reduce the cost base of the unit for the purpose of computing capital gains tax at the time when the unitholder ultimately sells the unit," Vishwas Panjiar, partner at Nangia Andersen said.

In the Budget for 2023-24, the government has proposed that InvIT/REIT distribution by way of 'repayment of debt' to the unit holders will be covered under the ambit of taxation as "other income", net of the cost of acquisition of the unit. However, no redemption of units occurs at the time of the return of debt by InvITs as there is no such provision under the Sebi norms.

The Budget proposal was seen to have an impact on listed trusts like Brookfield REIT, Embassy REIT and Mindspace REIT, given that bulk of their income distribute to unitholders is in the form of loan repayment. InvITs also typically reward the investors through loan amortisation, and the Budget proposal was feared to hit the trusts floated by public sector entities like NHAI and PowerGrid, among several other listed ones.

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